the LEC estimate and the SCM estimate is accounted for in the central office and remote distribution unit categories. Cost causative analysis will be crucial here to ensure that telephone ratepayers do not pick up costs associated with either video dialtone or the integration of video and telephony.

Recent evidence suggests that digital line carrier (DLC) for telephony can lower costs by as much as 30 percent.[37] For several decades, the local exchange companies have claimed that the cost of network access is stagnant, while efficiencies in switching and other network functions were dramatic. This failure to ascribe any of the benefits of increased efficiency to network access is the basis for the LEC argument that the cross-subsidy to local service was growing massively. It is now clear that the cost of loop is undergoing a revolution and has been doing so for some years.

The companies identify a large part of these costs as common. The Table illustrates that in the case of Bell Atlantic, common costs are 60 percent of total costs. In the case of U.S. West, it is 71 percent. All of the feeder, distribution and drop facilities are treated as common. A small part of the central office facilities are treated as common. Simply put, the loop is treated as a common cost of telephony and video. A figure of $400 for a loop is quite low. Even if we were to add about $100 for the separate telephone drop that splits from the video, the cost is quite low.

The LEC's own numbers suggest that the cost of building a local telephone network, even without taking into account common costs between local, long distance, enhanced services and video, appears to be in the range of $600 to $700 in capital costs. The embedded costs the LECs claim is in the range of $1000 to $1200. Thus, it is not surprising to find, as indicated in Table 1, that most Commissions have rejected LEC cost claims and set rates at roughly half the LEC claims.

B. EXPLAINING THE GAP BETWEEN EMBEDDED AND EFFICIENT COSTS

A number of factors may be contributing to the differences between the LECs' claimed embedded costs and efficient costs including:

- o Excess profits
- o Strategic investment
- o Inefficiencies
- o Misallocated costs

The State commissions are not obligated to insure or even allow the recovery of any of these costs. None of these costs deserves support from the universal service fund.

Table 3 presents two estimates of the important role that these factors play in explaining the gap between embedded costs and the cost of providing efficient telephone services. One estimate uses materials from a rate case in Indiana, which saw extensive evidence on cost analysis developed. That case was settled with a rate reduction for local service of approximately $3.00 per month, including the elimination of the state subscriber line charge. The second estimate uses recent national numbers developed primarily for the FCC's universal service and local competition proceedings. Both show that the gap can be readily explained by the above four factors.

1. Excess Profits

Excess profits are a primary source of the problem. In the Indiana case, the company's underlying cost model relied on a cost of money of 12.67 percent. The People's Counsel estimated the cost of money at less than 10 percent. At the national level, consumer advocates have documented excessive profits for local exchange companies on the order of $5 to $6 billion for the past several years.[38] Including tax effects, this equates to approximately $5 per subscriber per month.

TABLE 3
RECONCILING EMBEDDED COSTS WITH EFFICIENT COSTS
LOCAL RESIDENTIAL TELEPHONE SERVICE
(DOLLARS PER MONTH)

	INDIANA	NATIONAL
	a/	b/
1. EMBEDDED COST	30.25	33.00
	c/	(d)
2. EXCESS PROFIT	2.25	5.00
	c/	e/ f/
3. STRATEGIC INVESTMENT	3.00	3.00
	c/	f/
4. INEFFICIENCY	4.00	4.00
5. MISSALLOCATED	c/	c/
TOLL	4.50	4.50
	c/	g/
ENHANCED/BUSINESS	1.00	6.00
6. LOCAL RESIDENTIAL COST OF SERVICES 1-(2+3+4+5)	14.50	10.50
	h/	I/
7. TSLRIC ESTIMATES	14.93 - 18.22	16.71 - 21.35
8. TSLRIC - ALLOCATION [7-5]	9.43 - 12.72	6.21 - 10.85
	a/	j/
9. LOCAL RATES (NO TAXES)	15.35	16.80

SOURCES: See text for discussion.

(a) Converted to a Monthly per line basis from "Testimony of Trevor R. Roycroft, Public's Exhibit 1," pp. 134-136, in State of Indiana, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075

(b) "Comments of U S West, Inc.," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, Schedule 3.

© "Testimony of Harold L. Rees, Public's Exhibit No. 3," p. 44, both in State of Indiana, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075

(d) Mark N. Cooper, Milking the Monopoly: Excess Earnings and Diversification of the Baby Bells Since Divestiture, (Consumer Federation of America, February 1994)

(e) Lee Selwyn, Analysis of Incumbent LEC Embedded Investment (ETI, May 1996), Table 6; Kenneth C. Baseman and Harold V. Gieson, Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by Local Exchange Carriers (MiCRA, December, 1995).

(f) Hatfield Associates, The Cost of Basic Network Elements: Theory Modeling and Policy Implications, March 1996, Table 5.

(g) Susan M. Baldwyn and Lee L. Selwyn, The Cost of Universal Service: A Critical Assessment of the Benchmark Cost Model (ETI, April, 1996), p. 76, shows approximately 20 percent of operating expenses resulting from the acceleration of depreciation due to pursuit of competitive and business services and marketing expenses targeted at business services.

(h) David Gable, Current Issues in the Pricing of Voice Telephone Services (American Association of Retired Persons, 1995), p. 17, and "Testimony of David Gable, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part Its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole Its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075; BCM -Benchmark Cost Model: A Joint Submission by MCI Communications Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc., CC Docket No. 80-286, December 1, 1995. Hatfield II - Hatfield Associates Inc., The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, March, 1996.

(I) Hatfield: I - Hatfield Associates Inc., The Cost of Basic Universal Service, July 1994, p. 4; II - Hatfield Associates Inc., The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, March, 1996. BCM - Benchmark Cost Model: A Joint Submission by MCI Communications Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc., CC Docket No.

80-286, December 1, 1995.

(j) Industry Analysis Division, Common Carrier Bureau. Trends in Telephone Service (Federal Communications Commission, May 1996), Table 6.

2. Strategic Investments

Strategic costs are a second major component of the gap. These are assets deployed primarily to meet demand in competitive segments or non-telecommunications businesses. The FCC has recently recognized that this is a massive problem, with huge quantities of underutilized fiber and switching capacity deployed throughout the network.[39] In Indiana, the People's Counsel conducted a close review of the allocators used to assign costs to the residential class and found gross over-allocation of plant to that category.[40] Among the major categories of strategic investment were technologies to enhance Centrex offerings (also identified at the National level as a problem), system signaling seven and ISDN costs primarily meeting business needs but assigned to residential, and switching costs allocated on the basis of average use, rather than peak use. These analyses demonstrate that between 10 and 20 percent of the total plant in service has been deployed for these strategic investments. This works out to between $3.00 and $4.00 per month per subscriber.

A similar analysis has recently been conducted at the national level.[41] It estimates that 20 percent of network investment since 1990 cannot be explained by basic service needs.

3. Inefficiencies

The third major category of costs that fill the gap between embedded and efficient costs are inefficiencies. These are primarily made up of extremely large overhead loading (including marketing and general corporate expenses) assigned to residential and basic service. Both the Indiana People's Counsel and the national estimates place this figure at approximately 15 percent of the claimed revenue requirement. This works out to roughly $3.00 to $4.00 per month.

4. Misallocated Costs

As previously noted, consumer advocates, state regulators, and some companies believe that there is another major problem of cost misallocation. Long distance and enhanced services utilize the network and must either have costs attributed to them or have their revenues included in the cost/revenue calculation. For instance, the Indiana People's Counsel claimed that 30 percent of total costs should be allocated to the toll market. Approximately $4.50 should be taken into account either as a cost or as a revenue (CCL plus intraLATA long distance). This would be equal to the national average CCL charge of $2.50, plus at least another $2 for intraLATA toll use of the network.

Similarly, some of the costs of the network have been incurred to provide enhanced services. The Indiana People's Counsel identified at least $1.30 of enhanced service revenues which should be attributed to local to offset these costs.

C. CONCLUSION

Thus, we can easily chart the path from the claimed costs of the local exchange companies to the efficient costs of basic service as estimated by a number of state Commissions and third parties. The $20 gap is made up of roughly equal parts of excess profits, strategic investments, inefficiencies and misallocated costs.

In a competitive market, these costs would not be recovered from basic service customers. The excess profits and inefficiencies would simply be competed away. The strategic investments and misallocated costs would have to be recovered from customers of the services for which those costs have been incurred. The next chapter examines the opportunity to recover these strategic costs and misallocated costs from the sale of other services.

IV. EXPANDING MARKETS AND THE COST OF BASIC SERVICE

A. NEW OPPORTUNITIES TO RECOVER COSTS

The fact that the difference between embedded costs and efficient costs can be largely explained by excess profits, inefficiencies, strategic investments and misallocated costs, suggests that we should expect to see these costs competed away as competition increases. They certainly should not be shifted onto basic residential services, which are likely to be the least competitive of all services. Moreover, a large part of these costs may actually be recovered, legitimately, in new markets. Many of the strategic investments and much of the excess capacity have been deployed to support advanced business and video services. These markets will be made more readily available under the 1996 Act.

As Table 4 shows, the markets which have been opened to local exchange companies equal or exceed the current markets in which these companies provide services. It is absolutely clear that the opportunities they gain equal or outweigh any additional risk they encounter. Not only has the long distance market been opened to the LECs, but entry into the cable market has been eased. Moreover, a moratorium on competition for intraLATA long distance actually protects one of their markets from competition in the near-term.

It is even more important to realize that the very joint and common costs that the LEC claim they could not recover under the FCC's contemplated pricing approach to unbundling of network facilities, could easily be recovered in the new lines of business. For example, the most highly developed video dialtone proposals submitted to the FCC showed that joint and common costs between video and telephony would be in the range of 60 to 75 percent.

TABLE 4:
TOTAL VALUE OF MARKETS ALTERED BY THE 1996 TELECOMMUNICATIONS ACT:
(Billions of Dollars)

	GREATER RISK	GREATER REWARD/LESS RISK
LOCAL EXCHANGE	42	
PRIVATE LINE, CELLULAR, MISC. ACCESS	24 35	
INTRALATA		13
CABLE		21
INTERLATA		67
MANUFACTURING		44
TOTAL	101	145

SOURCES: Industrial Analysis Division, Trends in Telephone Service, Federal Communications Commission, May 1996, Tables 30, 31, 32; Standard and Poors Industry Surveys: Telecommunictions, December 7, 1995, estimate of telecommunications network equipment.

Certainly long distance service will entail at least this level of joint and common costs. Excess switching capacity and fiber trunking, which exist in large quantities in the network, can be used to provide long distance service. Efforts by several of the companies to merge, if successful, will assist in the utilization of these strategically deployed facilities to enter the long distance market as well.

For regulators to recognize only the down-side potential of competition for LECs but not the upside would bestow all the benefits on the companies while imposing all the costs on ratepayers. The exposure to risk in their current businesses is more than offset by the opportunity of revenue in the businesses which will be opened to them.

B. PROVIDING LONG DISTANCE OVER EMBEDDED NETWORK FACILITIES

The LECs admit that entry into long distance is a profit and revenue opportunity.[42] Even if they were to lose some revenue in their current lines of business, above and beyond the billions of excess built-in, they could more than make up those revenues in the businesses opened up to them. No statement better summarizes the vast opportunities opened to the LECs than the following from its trade association

> The passage of the Act offers additional opportunities for many new market entrants. Specifically, it breaks down regulatory barriers and opens up local telephone, long-distance service and cable television to competition, thereby eliminating many of the restrictions that have prevented telephone companies, long-distance carriers and cable and utility companies from competing with each other. IXCs, cable television companies, RBOCs, and new entrants in the telecommunications marketplace all stand to gain a great deal from the provisions in the new Act. Specifically, the Act removes the ban that prohibited the RBOCs from entering the interstate market that was essentially dominated by AT&T, MCI and Sprint.[43]

The LEC admission of a revenue opportunity does not fully reveal the importance of the potential reward opened to the LECs by the new law. Above all, LECs have an immense opportunity of profit from entry into the long distance business, precisely because it is a proven market which they can service using the network that they have previously deployed. Because they have overbuilt their networks, they can add long distance with little incremental capital costs. Merrill Lynch has made this very point in its most recent analysis of the local exchange industry. It refers to long distance as

> The ultimate vertical service... because , like other vertical features, long distance can be offered to already existing customers with minimal capital investment but unlike vertical features, customers do not have to be convinced to use it. They already are using it; they just need to be convinced to change suppliers... **In our view, the high incremental margins and low capital intensity of long distance enables the RBOCs and GTE to gain enough to offset the pain of losing (what we believe will be) comparable market share in the local telephone market.**[44]

It is ironic that for GTE, the loudest complainer about the taking of its property under the new

law, long distance is an immediate source of profit. For GTE, the potential is particularly great, since it does not have to await approval for entry into long distance.[45]

> GTE has already begun to offer long distance services to its in-region customers and intends to gain 10% of its $4.8 billion addressable long distance market within 12 months with negligible costs to the bottom line. **How often is it that an industry wakes up one day, finds its addressable market expanded by 40% and can launch the new service without noticeable dilution and achieve positive earnings by the second year?** Most ventures of this magnitude require significant startup financing and take 4 or more years to achieve positive operating cash flow and several additional years to achieve positive EPS impact.[46]

J. P. Morgan points out that Southern New England Telephone (SNET), another of the most vociferous complainers about the taking of property, has already begun to exploit the long distance market.[47] Bear Stearns notes that the dramatic success of GTE and SNET has occurred without these companies having to offer large discounts off of current long distance rates, indicating that the margins available to local companies because of a favorable wholesale market could go directly to the bottom line.[48]

Wall Street has concluded that not only do the LECs have a golden profit opportunity in the long distance market, but they have a number of advantages because of the nature of the local and long distance markets. These include the following.

- Discounts for use of facilities for entry into long distance are likely to be much higher.[49]
- LECs enter the long distance market from a stronger infrastructure and marketing base.[50]
- Existing excess capacity will make bundling long distance and other services easy and highly profitable for the LECs.[51]

Data produced in the proposed Bell Atlantic-Nynex merger demonstrates the immense value that LECs place on entry into the long distance market and the profit opportunity it presents.[52] The

following analysis uses data that was unsealed during the New York State investigation into the impact of the merger to estimate the impact of the proposed merger on the return on equity of the New Bell Atlantic.

Wall Street analysts have pointed to the large potential financial benefits of internalizing long distance traffic within the company.

> The key reason to this deal (as well as the SBC*(SBC $49 3/4)-PacTel*(PAC $34) is the opportunity to gain a larger territory and greater market power to enter in-region long distance once all regulatory hurdles are met (which we continue to believe will take until the year 2000).[53]
>
> Contiguous properties also result in a greater amount of long distance traffic flowing between the two regions. Individually, percentage of interlata long distance traffic that originates and terminates within its geographic region is 35% for BEL and 22% for NYN. However, on a combined basis the amount of traffic that originates and terminates within the expanded region jumps to 45% because of interlata traffic between the two regions, notably the New York to Washington and New York to New Jersey.[54]
>
> We estimate that BEL may be able to reduce its cost of transport from $0.02 per minute to $0.01 per minute on the 45% of calls that originate and terminate in the new Bell Atlantic's region by carrying this traffic on its own network.[55]
>
> Assuming the company gains the stated goal of at least 20% market share in-region, it would gain $1.2 billion of revenue in this inter-region corridor (gross of access fees). Were the company able to handle these calls on its own network at a low incremental fixed cost, it could gain a 10% cost advantage (since long distance transport represents roughly 10% of revenue) which would then flow $120 million (10% of $1.2 billion) to the bottom line.[56]

The Wall Street analysts use company projections of a capture of 20 percent of in-region long distance to estimate cost savings to the company for the use of company facilities. In essence the analysts assume a low marginal cost ($.01) compared to a much higher going market rate ($.02). None of the analysts assumes that this difference would be competed away. The financial benefits of this internalization rests on the assumption that a great deal of traffic can be added to the existing

network of the merging companies at low incremental costs. To the extent that this represents excess capacity, clearly ratepayers have been bearing a burden for which they deserve to be compensated.

As Table 5 shows, internal documents indicate that the annual total

TABLE 5:
INCREMENTAL PRE-TAX INCREASES IN INCOME DUE TO ENTRY INTO LONG DISTANCE RESULTING FROM THE MERGER.
(Millions of Dollars)

	1998	1999	2000	2001
LD Transport and Operations	53	108	157	165
LD Revenue Gain	152	426	566	611
TOTAL	265	534	723	776

of cost reductions for long distance transport would reach over $150 million by the fourth year.

The Companies claim additional revenues as a result of the merger. The single most important increase in revenue would come from the long distance market. By the fourth year, the long distance net operating income gain is projected at $611. Thus, by capturing a 20 percent market share, part of which is attributable to the merger, the company projects an increase in net income of almost $800 million.

It is ironic to contrast this huge increase in income resulting from the entry into long distance with the public statements offered about the reasons for the merger. The companies have gone to great lengths to stress the benefits of synergies which would result in cost reductions of $600 million and capital savings of $250-300 million. That was only half the story; the other half was huge profits

from the long distance business. The bottom line impact of this increase in profits would be to raise the return on equity of the merged company by over 3 percentage points.

C. CONCLUSION

The early successes of the companies who have been allowed entry into long distance and the strong economic advantages that LECs have in entering long distance make it clear that the long distance opportunity is very real and must be recognized as offsetting any claims of competitive losses in local service. The strong economics of the underlying supply and demand conditions interact with recent deregulation of profits for many companies to produce a profit picture that excites the investment analysts.[57] In essence, the excess capacity which the LECs are trying to recover in basic rates has been predeployed for the purposes of selling enhanced services and second line. If local exchange companies raise the rate for first lines (based on the inclusion of costs of second lines) then continue to sell more and more second lines, their profits will go through the roof. However, because most LECs are no longer subject to rate of return regulation, consumers overpay and the LECs get to keep it all.

VII. PREVIOUSLY COMPENSATED RISK

The previous two chapters have demonstrated that the cost claims of the LECs are overstated and that the revenue opportunities provided to them in the future are vast. Since the very same cost base would be used to obtain the additional revenues and increases in net income, these must be taken into account when estimating any costs that might be stranded by a change in public policy with respect to market structure and regulation. Based upon this empirical analysis, we conclude that there is little likelihood that any claim to stranded investment recovery will be supportable.

This chapter addresses a different issue. Even if it could be shown that some quantity of costs are stranded by public policy changes, this chapter shows that the LECs have already been compensated for such risks. To establish stranded investment funds would compensate them a second time for those risks. This would be unfair to ratepayers and would undermine competition.

A. LECS HAVE EARNED EXTREMELY HIGH RISK PREMIUMS SINCE DIVESTITURE

Traditional rate of return regulation allows utilities an opportunity to earn a stable return on investment. The target rate of return is set to be commensurate with the risk of the investment. There is no guarantee that the allowed rate of return will be achieved, however, and the utility is supposed to work hard to hit its target.

In the quarter century before divestiture, telecommunications investment by AT&T, the near national telephone monopoly, earned a stable rate of return that was between one and two percentage points below that of the manufacturing sector as a whole (as Table 6 shows).[58] It was about 2.5 percentage points below that of the Standard and Poors 400. It was about 3.5 percentage points

TABLE 6:
AVERAGE ANNUAL BOND YIELD AND RETURN ON EQUITY,
BELL SYSTEM COMPARED TO LOWER AND HIGHER RISK INVESTMENTS
(Percentage Points)

	PRE-DIVESTITURE (1957-1983)	POST-DIVESTITURE (1984-1995)	CHANGE
ATT/ RHCS	10.1	15.1	+5.0
OTHER INDUSTRIES			
ALL MANUFACTURING	11.7	12.0	.3
STANDARD & POORS	12.6	12.1	- .5
BUSINESS WEEK 1000	13.5	12.6	- .9
GOVERNMENT/ RISK FREE CAPITAL			
3 YEAR T-BILL	6.7	7.6	+ .9
10 YEAR T-BOND	6.8	8.3	+1.5
ATT/RBOC COMPARED TO:			
OTHER INDUSTRIES			
ALL MANUFACT.	-1.6	+3.1	+4.7
STANDARD & POORS	-2.5	+2.6	+5.1
BUSINESS WEEK 1000	-3.4	+2.5	+5.9
GOVERNMENT/RISK FREE CAPITAL			
3-YEAR T-BILL	+3.4	+7.5	+4.1
10-YEAR T-BOND	+3.3	+6.8	+3.5

SOURCES: Economic Report of the President: 1995, Table B-72 for bond yields and B-94 for all manufacturing; Standard and Poors, Analysts Handbook, various issues; Business Week, Annual Specials, various issues; Alfred Kahn, "Utility Regulation Revisited," in A.L. Danielsen and D. R. Kammerschen (eds), Current Issues in Public Utility Economics (Lexington, Lexington Books, 1983), Table, 6.1, for predivestiture AT&T returns; Federal Communications Commission, Statistics of Communications Common Carriers, various issues, for post divestiture RBOCs.

lower than the Business Week 1000. The fact that AT&T's return was substantially below the average for other businesses reflects the fact that AT&T faced less risk in its franchise monopoly businesses than other businesses did.

At the same time, the allowed rate of return and the achieved rate of return were above the 3-year and 10-year Treasury bond rate by a few percentage points. This is a relatively risk free investment of a term similar to that for utility stocks. Historically, the risk premium was a few percentage points. In particular, in the decade or so prior to divestiture, AT&T earned only two points above the T-bond rate.

Since divestiture this pattern has been turned on its head. The return on equity has been 3.5 percentage points more than all manufacturing and 2.5 percentage points more than Standard and Poors (S&P) and Business Week 1000 companies. The change in earnings in comparison to firms in the economy, which face much greater competition than local telephone companies, is striking -- a swing of 5 percentage points in return on equity. The risk premium more than doubled, to around 7 percent, when measured as the return on equity.

The cumulative effect of these excessive returns has had a dramatic impact on the returns realized by investors (see Table 7). On average, the RBOCs have realized a total return to investors that is about three to four points higher than the Standard and Poors 500 or the Forbes 500. The risk premium earned since divestiture is over 9 percentage points, when measured as the total return to investors

TABLE 7:
TOTAL RETURN TO INVESTORS, AVERAGE ANNUAL RETURN,

	(a) 5 YEAR	(b) 10 YEAR	© 12 YEAR
AMERITECH	14.1	18.8	20.7
BELL ATLANTIC	10.5	15.6	17.1
BELL SOUTH	12.9	16.1	17.2
NYNEX	9.0	14.8	17.2
PACTEL	9.3	14.5	16.1
SBC	17.0	20.7	20.2
USW	10.5	NA	14.9
AVG .	11.9	NA	17.9
ALL INDUST	9.1	13.9	14.6
30 YEAR T-BOND	6.9	7.9	8.6

SOURCES: (a) Merril Lynch, Global Securities Research and Economics Groups, Telecommunications Services - RBOCs & GTE, May 14, 1996, Chart 1, S&P 500; (b) Fortune, April 29, 1996, Fortune 500; © Business Week, May 20, 1996, S&P 500.

B. LECS HAVE FAILED TO TAKE WRITE-OFFS THAT ARE PART OF THE ROUTINE PROCESS OF INVESTMENT AND RETURN ON INVESTMENT

This extremely high risk premium, sustained for more than a decade, indicates that RBOCs have already been compensated handsomely for risks. Policy makers, the courts and commissions have an obligation to analyze the nature of stranded investment claims before they allow recovery of stranded investment. This requires careful consideration of the circumstances under which investments were made and the extent to which management exercised choice in keeping assets on the books.

Some investments may have been rendered obsolete in pursuit of marketing opportunities.

Some investments may have been rendered obsolete as a result of technological progress, which the Commission certainly could not and never promised to control. Some investments may have gone bad because they were management mistakes. Some investments may have gone bad because of bad luck.

None of these reasons for stranded investment have anything to do with the obligation to serve and they should not be compensated as if they were a result of the obligation to serve. Competitive firms routinely write down the value of assets for a variety of reasons, when they feel that they are under performing.

There has never been a guarantee of recovery of costs in the "social contract" between the company and the people, only an opportunity to earn a return commensurate with the risk incurred. Therefore, the key task is to separate out risks which the company incurred knowingly and for which it has been compensated from risks for which it has not been compensated, would not have taken but for the "social contract," and no longer believes it can be compensated for because of the alleged change in the terms of the "social contract."

There is at least one specific measure a Commission could use as an indicator of the risk of being stranded. The Commission can identify comparable companies and use them to both identtify a reasonable rate of return and typical levels of write offs. It could identify the revenue stream associate with the assets which are claimed to be stranded and whether it has been written down in value. It could calculate the write-down of assets taken by these companies in the period just prior to and during the life of the stranded asset.

- This potential write down of assets was part of the expectation of comparable risk. To the extent that the incumbent telephone company has failed to take write-downs of a similar order of magnitude (relative

to its assets, e.g. as a percentage of assets) it is seeking to be overcompensated for the stranding of investment.

- The incumbent LEC was allowed a comparable rate of return, but did not take a comparable write-down of assets. It now seeks a return of and on those assets which comparable companies have written down and taken off their books.

Table 8 presents an order-of-magnitude estimate of these routine write offs of investments and other "extraordinary" charges taken against income. It uses 34 non-utility companies which were identified by the Federal Communications Commission for purposes of establishing the rate of return to be allowed to utilities.[59] In essence, these were to be companies with risks comparable to long distance companies -- a much riskier business than local companies faced in the past decade.

We have identified the total return to investors earned by these companies in the past decade as calculated by Forbes. This spans almost the entirety of the since divestiture. It can be seen that the Regional Bell Operating Companies plus GTE have earned a higher total return than these comparison companies. The Table also identifies the charges against income taken by these companies over that same ten-year period. In essence, these companies were writing off assets and reducing income for extraordinary purposes, and while they were producing a total return to investors of just under 15 percent. The write offs equal approximately 20 percent of the total assets of the year-end 1995 assets of the comparison companies.

For tax purposes, the RBOCs have taken significant write-offs as well. Since 1991 the y have been taking huge charges against their income for accounting changes, restructuring, and claimed competitive impacts. In total they have claimed about $32 billion of such charges. They have not taken these charges or write-offs in their regulated operations, however. Having earned a large risk premium on these assets, the Baby Bells hope regulators will compensate them a second time for

TABLE 8
RETURNS AND WRITE-OFFS OF LECS AND COMPARISON COMPANIES

	TOTAL RETURN TO INVESTORS 86-95 (ANNUAL AVG.)		WRITE OFFS AND CHARGES AGAINST INCOME 86-95 (% OF 1995 ASSETS)	
ABBOTT	20		8	
ALBERTO-CULVER	12		2	
AMOCO	14		15	
CAMPBELL SOUP	20		34	
CHEVRON	16		68	
CONSOLIDATED FREIGHT	2		15	
CONSOLIDATED PAPERS	11		5	
DONNELLEY & SONS		12		6
DOVER	16		3	
EXXON	17		5	
GENERAL ELECTRIC	18		9	
GENERAL SIGNAL	7		53	
GARINGER	15		5	
IBM	-2		87	
KELLOGG	19		23	
KIMBERLY-CLARK	21		41	
LUBRIZOIL	11		16	
MC DONALDS	19		0	
MERCK	27		8	
MINNESOTA MINING	15		5	
NORFOLK SOUTHERN	15		14	
NUCOR	21		0	
PFIZER	21		24	
PITNEY BOWES	17		20	
PROCTOER & GAMBLE	20		10	
RAYTHEON	17		12	
ROCKWELL	15		28	
SARA LEE	21		11	
SEARS	11		35	
TIME WARNER	11		3	
UNION CAMP	10		3	
UNION PACIFIC	13		14	
WESTINGHOUSE	0		138	
WHIRLPOOL	11		17	
WEIGHTED	10		47	
BELL SOUTH	16		16	
BELL ATLANTIC	16		29	
AMERITECH	19		36	
NYNEX	15		31	
SCB	21		31	
PACTEL	15		58	
USWEST	12		22	
GTE	18		23	
WEIGHTED	17		28	

SOURCES: TOTAL RETURN = FORTUNE 500; WRITE OFFS = MOODY'S.

these risks, when the risks actually materialize (i.e. when real competition appears). The result is to present a completely distorted picture of their financial structure.

RBOCs have thus achieved a higher total return than comparable businesses with similar write-offs. However, they have never taken those write-offs for regulatory purposes. As a result, they now claim more assets and more equity in their regulated telephone subsidiaries than they do in their total holding companies. The RHCs now claim more equity in the telephone subsidiaries than they have in the total holding companies (see Table 9). This implies negative equity in the unregulated businesses. The debt/equity ratios in the telephone and non-BOC businesses were always backwards. That is, the Baby Bells claimed much more equity in the lower risk telephone businesses than in their high risk unregulated businesses.

TABLE 9:
FINANCIAL AND OPERATING CHARACTERISTICS
OF OPERATING AND OTHER BELL COMPANIES

	1995		1991		CHANGE 1991-1995	
	BOC	NON-BOC	BOC	NON-BOC	BOC	NON-BOC
ASSETS	149.7	3.9	143.9	31.3	+5.8	-27.4
EQUITY	53.0	-2.5	58.3	5.3	-5.3	-8.8
DEBT	35.4	9.6	37.2	9.1	-1.8	+.5
REVENUE	74.8	11.7	67.0	12.6	+7.8	-.9
INCOME	8.1	-1.1	8.2	-.7	+ .1	-.4

SOURCES: Annual Reports, Common Carrier Bureau, Statistics of Common Carriers (Federal Communications Commission, various issues).

One would normally expect the opposite to be the case. Markets would insist on higher equity capital in the more risky unregulated ventures. Risky ventures that are highly leveraged, as the RBOCs unregulated activities are, would require very high interest rates. The RBOCs have manipulated the capital structure of their subsidiaries and used the BOCs to leverage debt of the non-BOCs. The result is that cash flow from monopoly ratepayers underwrites borrowing in the non-BOC entities.

The core monopoly businesses have been used to carry much higher levels of equity, raising the cost of capital for ratepayers, but also providing a stable return to investors, while the risky unregulated businesses have been financed with debt, which is guaranteed by monopoly cash flow. The RBOCs thus maintain low equity ratios, without raising the cost of their debt dramatically, by having the ratepayer absorb the risk in the form of excess equity retained in the operating companies.

This creates high revenue requirements, large amounts of free cash for the holding company and stable earnings tied to the monopoly business. The dividends paid by the operating companies to the parent holding company have exceeded the total dividends paid by the company to shareholders. The excess dividends transferred to the parent exceed the total debt of the unregulated subsidiaries. Thus, not only does the parent guarantee the debt, but it has the cash flow from the operating telephone companies to back up the guarantee. The result is favorable overall financials and plenty of free cash to ensure that debt payments for the unregulated company will be covered by dividends from the operating company to the parent. The result of this subsidy is to give the RBOCs a tremendous financial advantage as they move into competitive businesses.

Although the equity and assets claimed by companies no longer reflect the true distribution of economic activity within the holding companies because of the manipulation of write-offs,[60] the

revenue streams and employment continue to reflect the massive accumulation of unregulated activities. The result of the misfit between accounting practices and economic reality is apparent. We observe over $10 billion in revenue and over 80,000 workers employed by unregulated subsidiaries that have negative equity and no assets. While the operating companies complain to regulators about a lack of profitability, the holding companies present a fabulously profitable picture to investors.

Depressed book returns for the RBOCs are an artifact of accounting manipulations and inappropriate cost-shifting to ratepayers. In addition to the mismatch of write-offs which has resulted in negative equity and asset positions of the unregulated subsidiaries, we also find that RBOC profitability is artificially depressed by other factors such as abusive transactions between the operating companies and the parent,[61] the misallocation of costs between local and non-local services, and strategic investments made by the operating companies that are and will continue to be used to support unregulated activities.

END NOTES

1. Telecommunications Act of 1996, Public L. No. 104-104, 110 Stat 56(1996)(hereafter, 1996 Law).

2. First Report and Order, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, August 8, 1996 (hereafter, Local Competition Order)..

3. The cost concept used by the FCC involves the estimation of the cost of providing a specific set of services using currently available technology deployed in the least-cost manner possible (Local Competition Order, Section VII).

4. The $20 billion dollar figure is the difference between the annual costs claimed by the local exchange companies and the forward looking least cost estimates provided by competitors. It is equal to the subsidy that the local companies and the long distance companies both claim exists (see Federal Communications Commission, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, In the Matter of Access Charge Reform, Price Cap Performance Review of Local Exchange Carriers, Transport Rate Structure and Pricing, and Usage of the Public Switched Network by Information Service and Internet Access Providers, CC Docket Nos. 96262, 94-1, 91-213, 96-263, December 23, 1996.

5. Local exchange service refers to what is generally known as local telephone service -- a dialtone, the placing of calls within an local calling area, and enhanced services, such as call waiting, etc

6. Exchange Access service refers to the offering of access to telephone service or facilities for the purposes of originating toll (long distance) services.

7. Three full sections of the 1996 Law deal with the effort to break down the barriers to entry into the local exchange market (Sections 251, 252, 253). One section (271) seeks to ensure that the conditions for competition are in place before the local exchange companies are allowed into in-region long distance.

8. Iowa Utilities Board, et al. v. Federal Communications Commission, et al., in the United States Court of Appeals for the Eighth Circuit, No. 96-3321 (hereafter Iowa Utilities Board).

9. For a summary of the Comments see "Reply Comments of the American Association of Retired Persons, Consumer Federation of America and Consumers Union," In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, May 7, 1996.

10. Iowa Utilities Board.